

# Overview

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Growth of Australia's major trading partners (MTPs) was around its long-run average in 2014. The US economy continued to strengthen, growing above its trend pace over the second half of 2014. In China, economic growth eased a little but was still very close to the authorities' target for 2014. Growth of investment and industrial production in China – which contribute significantly to the demand for commodities, including iron ore – have moderated over the past year or so, partly because of weak conditions in the residential property market. In Japan, economic activity has been weaker than expected since the increase in the consumption tax in April last year, but growth looks to have resumed in the December quarter. In the rest of east Asia, the pace of growth slowed a little over 2014. Economic activity in the euro area remains subdued.

Australia's MTP growth is expected to continue at around its pace of recent years in 2015 as a number of effects offset each other. Growth in China is expected to be a little lower in 2015, while growth in the US economy is expected to pick up further. The significant fall in oil prices, which has largely reflected an increase in global production, represents a sizeable positive supply shock for the global economy and is expected to provide a stimulus to growth for Australia's MTPs. The fall in oil prices is also putting downward pressure on global prices of goods and services. Other commodity prices have also declined in the past three months, though by much less than oil prices. This includes iron ore and, to a lesser extent, base metals prices. Prices of Australia's liquefied natural gas (LNG) exports are generally linked to the price of oil and are expected

to fall in the period ahead. The Australian terms of trade are expected to be lower as a result of these price developments, notwithstanding the benefit from the lower price of oil, of which Australia is a net importer.

Central bank actions were the main focus of financial markets over the past few months. The European Central Bank announced its intention to ease monetary policy further to prevent inflation from remaining below target for a prolonged period, by increasing both the size and scope of its asset purchase program to include government bonds. Several other central banks have eased policy and financial markets have pushed back their expectations for policy tightening by the Federal Reserve and other central banks. As a result of these actions, and some concerns about global growth and the risk of declining inflation, sovereign bond yields in the major markets have fallen significantly, particularly at longer maturities, although the size of the decline in yields is difficult to explain.

The increasingly divergent paths of monetary policy among the major advanced economies have led to some sizeable movements in exchange rates. Most notably, the Swiss franc has appreciated by around 15 per cent against the euro since the Swiss National Bank abandoned its exchange rate ceiling against the euro at an unscheduled meeting in January. While the US dollar has depreciated against the Swiss franc, it has appreciated further against most other currencies, notably the euro, and is around 10 per cent higher on a trade-weighted basis than it was in mid 2014. Nevertheless, in real terms the

US trade-weighted exchange rate remains below its long-term average.

Australian financial conditions remain very accommodative. Lending rates on the outstanding stock of housing and business loans have continued to edge lower, and yields on Australian government bonds have fallen considerably. The Australian dollar has depreciated by around 9 per cent against the US dollar since the previous *Statement*. On a trade-weighted basis it has depreciated by 7 per cent over the same period, and is currently 5 per cent below its early 2014 levels, although commodity prices have fallen by considerably more since then.

Available data since the previous *Statement* suggest that the domestic economy continued to grow at a below-trend pace over the second half of 2014. Resource exports and dwelling investment have grown strongly. Consumption growth remains a bit below average. Growth of private non-mining business investment and public demand remain subdued, while mining investment has fallen further.

Export volumes continued to grow strongly over the second half of 2014, driven by resource exports. Australian production of coal and iron ore is expected to remain at high levels, despite the large fall in prices over the past year. The production capacity for LNG is expected to rise over 2015. Service exports, including education and tourism, have increased a little over the past two years or so and are expected to rise further in response to the exchange rate depreciation.

Mining investment continued to decline as some current projects reached completion and very few new projects were commenced. This is expected to continue for some time. Non-mining business investment has been subdued over recent years and the recent data suggest that it will remain so into the first part of 2015.

Activity and prices in the housing market continue to be supported by the very low level of interest rates and strong population growth. Dwelling investment has grown strongly since mid 2013 and a range of

indicators point to further growth in the near term. Housing price inflation has eased from the very rapid rates seen in late 2013, although it remains relatively high, particularly in Sydney and Melbourne. Growth of owner-occupier housing credit has remained at around 6 per cent, but investor credit continues to grow at a noticeably faster rate.

Household consumption growth has picked up since early 2013, but is still below average. Consumption is being supported by very low interest rates, rising wealth, the decision by households to reduce their saving ratio gradually and, more recently, the decline in petrol prices. These factors have been offset to an extent by weak growth in labour income, reflecting subdued conditions in the labour market. Consumption growth is still expected to be a little faster than income growth, which implies a further gradual decline in the household saving ratio.

Although the most recent data on the labour market have been more positive, including stronger employment growth, measures of spare capacity have increased over the past year, consistent with a continuation of below-trend growth in economic activity. In particular, the unemployment rate increased gradually over 2014, continuing its trend of the past few years, and the participation rate and average hours worked remain below their levels of a few years ago. While leading indicators of labour demand have picked up since late 2013, at this stage they point to only modest employment growth and a slight rise in the unemployment rate in the near term. Meanwhile, labour cost pressures remain subdued. Wage growth remains low and unit labour costs have been little changed for more than two years.

CPI inflation declined to 1.7 per cent over the year to the December quarter, partly reflecting the direct effect of the large fall in oil prices and the repeal of the carbon price. The various measures of underlying inflation declined in year-ended terms to around 2¼ per cent. Prices of tradable items (excluding volatile items and tobacco) were little changed in the December quarter and over the year, following

a period of some years in which they had been in decline. The pass-through of the depreciation of the Australian dollar is expected to place upward pressure on the prices of tradable items for some time, but liaison reports suggest that retailers are currently finding it difficult to pass on the costs of higher import prices because of the highly competitive retail environment. Non-tradables inflation (excluding utility prices) was unchanged in the December quarter and continues to reflect the offsetting effects of weak domestic cost and margin pressures, and ongoing strength in the growth of new dwelling costs.

GDP growth is forecast to remain a bit below trend over the course of this year, before picking up to an above-trend pace in the latter part of the forecast period as consumption growth improves, non-mining business investment lifts and LNG exports increase. While the key forces shaping the outlook are much as they were at the time of the November *Statement*, the forecast for GDP growth has been revised a little lower in the near term. Notwithstanding the recent falls in oil prices, new information suggests that consumption growth and non-mining business investment are likely to pick up later than previously had been expected, and that LNG production is likely to ramp up a bit more gradually than earlier expected. Lower export prices are expected to dampen the growth of incomes and activity. In time, however, the recent further depreciation of the exchange rate and lower interest rates are expected to provide support to demand. As a result, GDP growth is expected to be above trend in the latter part of the forecast period.

The slightly weaker outlook for GDP growth in the near term implies that the unemployment rate is likely to rise a bit further and peak a bit later than earlier expected, before declining as growth picks up to an above-trend pace. The outlook for consumer price inflation has been revised lower since the previous *Statement*, reflecting the effects of the fall in oil prices and the weaker outlook for labour and product markets. These have more than offset the

upward pressure on prices anticipated to result from the further exchange rate depreciation. Headline inflation is expected to remain low for a time, before picking up a bit to be consistent with the inflation target at the end of the forecast period. Underlying inflation is expected to remain well contained and consistent with the target throughout the forecast period.

Overall, the risks to the global economic outlook appear to be broadly balanced. Weakness in the Chinese property market is an ongoing source of uncertainty for the growth in China's demand, including for some of Australia's key commodities. Chinese authorities have taken measures to support residential construction activity but, to date, housing market conditions remain subdued. Economic conditions in the United States could strengthen by more than forecast in response to still very stimulatory monetary policy and the decline in oil prices. More generally, the extent of the stimulus to global economic activity from the decline in oil prices is a source of uncertainty.

Moreover, the outlook for commodity prices is a key source of uncertainty for both the global and the domestic economies. The outlook for prices will depend on a number of factors, including the responsiveness of future supply to the decline in commodity prices seen to date. The outlook for the exchange rate is also an important consideration for the forecasts for the domestic economy. Most estimates suggest that the Australian dollar remains above its fundamental value, given the substantial decline in commodity prices over the past year. Increasingly divergent monetary policies in the major economies are likely to continue to have an important bearing on exchange rate developments.

There is considerable uncertainty about the combined effect of the fall in oil prices and the depreciation of the exchange rate on domestic economic activity and inflation. Lower oil prices will provide support to household demand and benefit businesses (outside the oil and gas sectors). The lower exchange rate will help to switch demand

to domestic sources of production as it pushes up import prices and improves the competitiveness of firms in the traded sector. The magnitude and timing of these effects are, as always, uncertain. The same is true of the extent to which the exchange rate depreciation passes through to consumer prices; this could be slower or faster than historical relationships suggest.

The timing and extent of the expected decline in mining investment and the anticipated recovery in non-mining activity remain key uncertainties for the domestic outlook. While this transition has been unfolding for some time, assisted by the very low level of interest rates, there is a risk that the recent run of moderate growth in household consumption could persist. However, the potential for ongoing strength in housing price inflation across the country could be associated with stronger-than-expected growth in consumption. Given the large increases in housing prices in some regions and ongoing strength in lending to investors in housing assets, housing market developments will need to be watched carefully. The Bank is working with other regulators to assess and contain economic risks that may arise from the housing market.

The timing and speed of the anticipated recovery in non-mining business investment remains uncertain. While the recent data suggest that the anticipated pick-up will occur later than had earlier been expected, the fundamental factors supporting investment remain in place, including very low interest rates, strong population growth and a period of weak investment over the past few years. If the

appetite for businesses to take on risk improves, the eventual pick-up in non-mining business investment could be stronger than currently forecast.

Prior to the February Board meeting, the cash rate had been at the same level since August 2013. Interest rates faced by households and firms had declined a little over this period. Very low interest rates have contributed to a pick-up in the growth of non-mining activity. The recent large fall in oil prices, if sustained, will also help to bolster domestic demand. However, over recent months there have been fewer indications of a near-term strengthening in growth than previous forecasts would have implied. Hence, growth overall is now forecast to remain at a below-trend pace somewhat longer than had earlier been expected. Accordingly, the economy is expected to be operating with a degree of spare capacity for some time yet, and domestic cost pressures are likely to remain subdued and inflation well contained. In addition, while the exchange rate has depreciated, it remains above most estimates of its fundamental value, particularly given the significant falls in key commodity prices, and so is providing less assistance in delivering balanced growth in the economy than it could.

Given this assessment, and informed by a set of forecasts based on an unchanged cash rate, the Board judged at its February meeting that a further 25 basis point reduction in the cash rate was appropriate. This decision is expected to provide some additional support to demand, thus fostering sustainable growth and inflation outcomes consistent with the inflation target. ✎